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In the Supreme Court of the United States

OCTOBER TERM, 1967

PROTECTIVE COMMITTEE FOR INDEPENDENT STOCKHOLDERS OF TMT TRAILER FERRY, INC., PETITIONER

v.

C. GORDON ANDERSON, TRUSTEE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

RALPH S. SPRITZER,
Assistant Solicitor General,
DANIEL M. FRIEDMAN,
J. NICHOLAS MCGATH, JR.,
Assistants to the Solicitor General,
Department of Justice,
Washington, D.C. 20530.

PHILIP A. LOOMIS, JR.,
General Counsel,
DAVID FERBER,
Solicitor,
PAUL GONSON,
Special Counsel,
[illegible],
THOMAS W. ARMSTRONG,
Attorneys,
Securities and Exchange Commission,
Washington, D.C. 20549.

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v.

C. GORDON ANDERSON, TRUSTEE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION[1]

OPINIONS BELOW

The opinions of the district court (II 370, 387, 881; III 260, 3[illegible], 387, 389)[2] are unreported. The opinions of the court of appeals (Pet. App. 3a, 6a) are reported at 334 F. 2d 118 and 364 F. 2d 936.

[1] The Securities and Exchange Commission participated as a party in this case in both the district court and the court of appeals (see *infra*, pp. 4–5), and thus is a respondent before this Court, although not named as such in the caption.

[2] We shall use the same form of record references that the petitioner uses, *i.e.*, the records in the three appeals to the court of appeals will be cited as "I", "II", and "III", respectively (see Petition, n. 1, p. 2). "Pet. App." refers to the Appendix to the Petition.

JURISDICTION

The judgment of the court of appeals was entered on August 12, 1966 (III 563). On November 8, 1966, Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including January 9, 1967. The petition was filed on the latter date, and was granted on May 29, 1967 (III 565; 387 U.S. 929). The jurisdiction of the Court rests on 28 U.S.C. 1254(1), and 11 U.S.C. 47c, 521.

QUESTIONS PRESENTED

The Securities and Exchange Commission will discuss the following questions in this brief:

1. Whether under Chapter X of the Bankruptcy Act, which provides for a disinterested trustee as the focal point of the reorganization, the trustee is precluded from assuming the presidency of the reorganized company; and whether a plan that contemplates that result may be confirmed.

2. Whether the district court erred in approving compromises of substantial claims against the debtor that were seriously disputed, when the record did not permit an adequate evaluation of the claims or disclose the basis for their settlement.

3. Whether, in approving as fair and equitable a plan of reorganization under which stockholders are excluded from participation because the debtor has been found insolvent, the method which the district court used in valuing the debtor was erroneous because it did not consider the future estimated earnings of the reorganized company.

4. Whether the courts below erred in refusing to

consider the merits of the stockholders' claims based on asserted violations of the securities laws.

5. Whether the district court erred in discharging the Stockholders Committee before the reorganization proceedings were completed, on the basis of its finding that the debtor was insolvent.

STATUTE INVOLVED

Many sections of Chapter X of the Bankruptcy Act (11 U.S.C. 501 *et seq.*) are involved; the following sections are particularly pertinent:

Section 156 (11 U.S.C. 556):

> Upon the approval of a petition, the judge shall, if the indebtedness of a debtor, liquidated as to amount and not contingent as to liability, is $250,000 or over, appoint one or more trustees. Any trustee appointed under this chapter shall be disinterested * * *. In any case where a trustee is appointed the judge may, for the purposes specified in section 189 of this Act, appoint as an additional trustee a person who is a director, officer, or employee of the debtor.

Section 158 (11 U.S.C. 558):

> A person shall not be deemed disinterested, for the purposes of section 156 and section 157 of this Act, if—
>
> (1) he is a creditor or stockholder of the debtor; or
>
> (2) he is or was an underwriter of any of the outstanding securities of the debtor or within five years prior to the date of the filing of the petition was the underwriter of any securities of the debtor; or

(3) he is, or was within two years prior to the date of the filing of the petition, a director, officer, or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter; or

(4) it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or such underwriter, or for any reason an interest materially adverse to the interests of any class of creditors or stockholders.

Section 221 (11 U.S.C. 621):

The judge shall confirm a plan if satisfied that—

* * * * *

(2) the plan is fair and equitable, and feasible;

* * * * *

(5) the identity, qualifications, and affiliations of the persons who are to be directors or officers, or voting trustees, if any, upon the consummation of the plan have been fully disclosed, and that the appointment of such persons to such offices, or their continuance therein, is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy.

STATEMENT

This case involves the reorganization of TMT Trailer Ferry, Inc. ("the debtor") under Chapter X of the Bankruptcy Act. Pursuant to Section 208 of that Chapter (11 U.S.C. 608),[3] the Commission has

[3] In Title 11 of the United States Code the numbers of the sections of the Bankruptcy Act comprising Chapter X are

been participating as a party since the inception of the reorganization proceeding, and for the most part has taken positions in the courts below consistent with the positions of the petitioner Stockholders Committee.[4]

1. HISTORY OF THE PROCEEDINGS

The debtor, incorporated in 1954, is engaged in the business of transporting loaded truck trailers and other freight on sea-going vessels between Florida and Puerto Rico. Between 1954 and 1957, it issued more than 4,000,000 shares of its common stock at prices ranging from $1 to $2.50 per share. Approximately one-half of these shares were acquired by insiders who resold the stock to public investors for various prices up to $4 a share. (II 584–589, 608–612.) Almost none of the shares sold to the public had been registered under the Securities Act of 1933 (15 U.S.C. 77a) (II 584–585).

The reorganization proceeding was initiated by an involuntary petition filed against the debtor in June, 1957, in the United States District Court for the Southern District of Florida. The court appointed the respondent C. Gordon Anderson as trustee. At that time more than 7,000 investors owned stock of the debtor (II 579–580). The district court, with the approval of the court of appeals, has confirmed a plan of reorganization under which these stockhold-

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higher by 400 than in the Act itself, *i.e.*, Section 208 of that Act is Section 608 of Title 11. We shall use the Bankruptcy Act rather than the Code section numbers.

[4] In response to an invitation by the Court for the United States to express its views at the petition stage (386 U.S. 901), the Commission filed a memorandum supporting the petition.

ers are excluded from participation in the reorganized corporation on the grounds (1) that the debtor is insolvent and (2) that their claims against the debtor based upon violations of the federal securities laws—violations, which, they alleged, entitled them to participate in any plan of reorganization as general creditors—were untimely made. 364 F. 2d 936.

Early in 1959 the district court had confirmed a plan of reorganization recommended by the trustee which would have given control of the corporation to the holders of preferred ship mortgages on the debtor's vessels ("the Caplan mortgage")[5] (II 473, 580), even though the court had questioned (I 29) and the trustee had objected to (I 34) the validity of their claims. At that time Anderson resigned as trustee to become president of the reorganized debtor (I 38, II 525) and a successor trustee was appointed (I 38). Shortly thereafter, the successor trustee petitioned, in effect, to vacate the order confirming the plan. He alleged that the holders of the Caplan mortgage and Merrill-Stevens Dry Dock & Repair Co. ("Merrill-Stevens"), also a substantial creditor, had entered into an agreement prior to acceptance of the plan which violated Section 221 of Chapter X, *i.e.*, an agreement by which the Caplan mortgage group would pay Merrill-Stevens in order to procure its acceptance of the plan (I 39–40). The successor trustee's petition, which the Commission supported (I 222), was denied,

[5] In the Petition these persons sometimes are called the Shaffer-Spitzer group (II 597–599). Shaffer and Spitzer succeeded Caplan as trustee under the preferred ship mortgage indenture.

the successor trustee was removed and Anderson was reinstated as trustee (I 38–41).

The Stockholders Committee appealed from the order of confirmation. The "appeal was predicated on the failure of the trial court to order the trustee to conduct an investigation * * * and on a failure of the court to conduct a hearing on insolvency of the debtor and to make findings of its assets and prospective earnings" (*TMT Trailer Ferry, Inc.* v. *Anderson,* 292 F. 2d 455, 457 (C.A. 5), certiorari denied *sub nom. Shaffer* v. *Anderson,* 368 U.S. 956). While that appeal was pending and after Caplan had filed "a petition for leave to consummate the plan," which Anderson supported, the Commission filed in the district court a petition for an investigation. The Commission asserted that "an investigation would disclose that the reorganization plan would be unfair in turning the corporation over to persons, or close associates of persons, who had dealt extensively in the stock of the company in transactions which * * * were of questionable legality" (*ibid.*). At a hearing on objections to consummation, all the parties agreed that an investigation should be made (*ibid.*).

Respondent Anderson, who, as noted above, had been reinstated as trustee (I 41), conducted the investigation. On July 1, 1960, he filed a lengthy report, in which he concluded that the debtor's business had been "wrecked by gross mismanagement, by unwise and unsound expansion financed primarily through the sale of securities in disregard of the protective provisions of the Securities Act of 1933" (II 584), and that the debtor had claims against holders of the Cap-

lan mortgage based on such mismanagement (II 606, 609, 614). The trustee recommended that the order confirming the 1959 plan be vacated (I 294). The district court vacated the order, and the court of appeals affirmed. *TMT Trailer Ferry, Inc.* v. *Anderson, supra.*

Early in 1962, two new plans of reorganization were proposed (II 41, 637). One plan, recommended by the trustee and known as the "internal plan," provided for reorganization of the debtor by the issuance of new common stock to its creditors, and had attached a proposed contract whereby the trustee would become president of the reorganized company (II 296–299, 695, 707). This plan, stated to be "Suggested by Certain Major Creditors" (II 41, 691), provided for "compromises" of the Caplan mortgage and the Merrill-Stevens claims almost in full, as more fully discussed *infra,* pp. 12–15 (II 41.5–41.6). Under the plan Merrill Stevens, in conjunction with the trustee and his general manager, would have gained initial control of the reorganized company.[6] The other plan, opposed by the trustee and known as the "cash plan," provided for the sale of the debtor's assets for cash to persons unconnected with the company, and the distribution of the cash to the creditors (II 711). The cash plan also provided for "compromises" of the Caplan and Merrill-Stevens claims (II 715). Neither plan provided for any participation by the stockholders.

[6] Under the formula outlined in the plan, Merrill-Stevens, because of the amount of its claims, nominated two of the seven directors of the reorganized company (II 348, 702, 706, III 353). Anderson and his general manager, B. E. Thouvenelle, were appointed directors by the court (II 987).

The Stockholders Committee, supported by the Commission, objected to both plans on the ground that the stockholders were improperly excluded and further objected to the internal plan because it (like the earlier plan) contemplated employing the trustee as president of the reorganized company (II 1086, 1087, 1089). After hearings on valuation, the district court found that the debtor was insolvent, and approved both plans as fair and equitable and feasible (II 380, 387.5–387.8).[7]

A majority of all classes of creditors (other than the United States, which had non-tax claims exceeding $900,000) accepted the internal plan (II 388). No acceptances were solicited from stockholders. In February 1963, the district court confirmed the plan (II 881).

In an appeal from that order of confirmation, the Stockholders Committee, supported by the Commission, contended that the plan was objectionable because it improperly excluded stockholders and contemplated that the trustee would serve as president of the reorganized company. The court of appeals, without reaching the other issues, held that the latter fact did not invalidate the plan.[8] In a separate appeal

[7] The internal plan had been amended prior to this time to eliminate the proposed contract for the trustee's employment as president of the reorganized company, but the plan did provide "that competent management, which might include present management," was to be employed. The order confirming the plan noted that the "identity, qualifications, and affiliations of the persons * * * to be directors and officers * * * upon the consummation of the * * * plan" had "been fully disclosed" (II 886; Pet. App. 4a).

[8] *Protective Committee, Etc.* v. *Anderson*, 334 F. 2d 118.

by the United States, however, the court held that the plan was defective because it failed to accord priority to the government's non-tax claims, and remanded the proceeding to the district court to determine whether the plan would be feasible with a provision for such treatment.[9]

On remand the district court ruled that the decisions of the court of appeals left open for it to determine only whether the plan would be feasible if the government's non-tax claims were given priority; it viewed the court of appeals' failure to reverse its rulings, such as that the stockholders had no interest in the reorganized company, as, in effect, an affirmance of those rulings (III 264).[10] After further hearings, the district court authorized amendments to the plan primarily to provide for the immediate cash payment of the United States' claims (III 71–73). The Commission, in its advisory report on the amended plan, stated that the plan appeared to be feasible but that it was not fair and equitable because it excluded the stockholders from participation in the reorganized company (III 235–239). The creditors accepted the amended plan (III 316, 325) and, over objections by the Committee (III 336) and the Commission (III 325), the district court confirmed it (III 328). For a third time the Stockholders Com-

[9] *United States v. Anderson*, 334 F. 2d 111, certiorari denied, 379 U.S. 879.

[10] The court of appeals subsequently held that the district court had misinterpreted the scope of those prior decisions, since the "reversal of the order of confirmation left open those issues not in terms discussed and decided." 364 F. 2d at 939.

mittee appealed from the order of confirmation, and the Commission supported its appeal.

2. SUMMARY OF THE AMENDED PLAN

The amended plan, as confirmed, provides for full payment in cash of costs and expenses of administration, of tax claims, of the non-tax claims of the United States, and of substantially all secured claims of less than $500. Secured creditors holding claims of more than that amount, except for the two such claims discussed *infra*, pp. 12–15, are given the choice of being paid in full over a five-year period or of participating as unsecured creditors. The latter are to receive *pro rata* a total of 1,300,000 shares of new common stock of the reorganized company (III 250–253).

No participation is provided for the stockholders, either as stockholders (since the plan states that the debtor is insolvent (III 253)), or pursuant to their claims arising from alleged violations of the federal securities laws (see pp. 15–16, 56–58, *infra*).

Respondent notes (Reply to the Commission's Memorandum in support of the Petition for a writ of certiorari, p. 4), that pursuant to this plan the directors of the reorganized company "have taken over the assets of the debtor and are running its business."[10a] The directors include respondent (III 393), who, we are advised, has become president of the reorganized company.

[10a] Each stock certificate of the reorganized company issued pursuant to the plan is required to bear a notation referring to the pending appeals (order entered Sept. 27, 1965).

3. THE CONTESTED CLAIMS

a. THE CLAIM OF THE HOLDERS OF THE CAPLAN MORTGAGE

The principal holders of the Caplan mortgage claim—the face amount of which was $330,000—were Joseph Abrams, Arthur Shaffer, and Robert Erdman (II 598–599). The trustee's report detailed the manner in which Shaffer and Abrams, sometimes with Erdman, caused the debtor to issue to them (or their nominees) in various transactions between December 1955 and June 1957 and at prices substantially below the market, a total of 1,825,500 shares of stock of the debtor. They resold these shares, without registration, to the investing public at large profits to themselves (II 605, 609–612). For example, according to the report, Abrams caused the debtor to exchange 385,000 shares of its stock for stock of another corporation he controlled; that corporation pledged the debtor's stock to a bank as collateral for a loan; when that corporation defaulted on the loan, the bank sold the stock to a syndicate headed by Abrams at two-thirds of its market price; the syndicate then sold the stock to the public (II 588). In another transaction characterized in the report as "fraudulent" (II 614), the debtor issued stock to a corporation in which Abrams had a substantial interest, in return for property of that corporation, on the basis of an "appraisal" of such property which far exceeded its value. This stock also was sold by that corporation through Abrams to the public (II 590–594, 611). The report also stated that during the periods when Abrams, Shaffer and Erdman were selling the debtor's stock to public investors, the debtor was caused to con-

duct a publicity campaign intended to create a speculative market in that stock (II 595).

The trustee concluded that Abrams, Shaffer and Erdman appeared to have violated the federal securities laws (II 612); that the debtor had defenses to the claims of the holders of the Caplan mortgage (II 606); and that the debtor had causes of action against Abrams, Shaffer and Erdman (II 609). He also concluded that the claims based on the Caplan mortgage should be subordinated to claims of innocent parties (II 614), and that Abrams, Shaffer and Erdman should be required to account for the profits they made through taking personal advantage of corporate opportunities (II 612–613).

After the trustee had filed his report of investigation and the district court had vacated its order confirming the 1959 plan (*supra*, pp. 7–8), both the trustee and the Commission filed objections to the Caplan mortgage claim (II 1093, 1096). The district court held no hearing on these objections. The plan that the court ultimately approved and confirmed, however, provided for a "compromise" under which $280,500 (the actual amount paid for the mortgage) was to be paid in cash in five annual installments;[11] and interest on that amount was to be allowed from January 1958 (the original due date), but was to be treated as an unsecured claim payable in stock (III 272).

[11] The plan was later amended to provide for the immediate payment of $250,000 in cash at the time of consummation, instead of $280,500 over five years (order entered September 21, 1965).

b. THE MERRILL-STEVENS CLAIMS

Merrill-Stevens filed claims totalling $1,628,284, of which $574,580 allegedly was secured by maritime liens on certain of the debtor's vessels (II 23). More than $1,000,000 of these claims was for the unpaid balance of Merrill-Stevens' charges for the conversion of one of the debtor's vessels (the Carib Queen) from a partially-completed naval ship into a self-propelled trailership. On its maiden voyage a series of boiler failures caused a breakdown of the vessel, necessitating extensive repairs (II 596, 1099–1100).

In 1961, the Commission, after an investigation, filed objections to these claims, urged that the trustee should investigate them, and suggested that they should be referred to a special master for hearing (II 1093)—because it appeared that the boiler failures resulted from Merrill-Stevens' negligence in performing its work of converting the vessel, and that the debtor therefore might be able to offset against the claims the expenses of repairing the vessel (III 405).

Although the trustee initially sought a reference to a special master for a hearing on the Merrill-Stevens claims (II 862), no such hearing was held. Instead, the trustee subsequently moved for the summary allowance of the claims on the ground that there was only a "remote" possibility of materially reducing them by litigating the objections filed against them (II 22). The Stockholders Committee, supported by the Commission (II 37, 1042, 1073), the Department of Justice (II 647) and the Caplan mortgage group

(II 636), filed objections. Despite these objections the plan ultimately approved and confirmed allowed these claims in full as unsecured claims (II 702). Merrill-Stevens received about 40 percent of the common stock of the reorganized company (III 251–252, 282).

C. THE STOCKHOLDERS' CLAIMS BASED ON ALLEGED VIOLATIONS OF THE FEDERAL SECURITIES LAWS

Based substantially on the facts in the trustee's report of investigation, the Stockholders Committee repeatedly asserted in various ways that non-management stockholders had claims against the debtor arising out of violations of the federal securities laws committed by the debtor acting in concert with Abrams, Shaffer and Erdman (see *supra*, pp. 12–13); and that such claims were entitled to be treated as claims of general unsecured creditors, irrespective of the solvency or insolvency of the debtor. The Stockholders Committee made this contention to the district court in connection with the formulation, approval and confirmation of the plants of reorganization (II 363, 364–368, 962, 1037, 1074, 1083, 1086–1088; see below, pp. 56–60.

The district court, without any hearing, denied these claims, stating:

> There is nothing in the record of these proceedings to indicate that any stockholders have any claims against the debtor that would permit them to recover on such a theory, which is intended to cover stockholders *who acquired their stock on the open market* and not from the debtor * * * and the time for filing claims expired several years ago. * * *
>
> Furthermore, the [Committee's] claim is filed

too late and is vague and indefinite as to who the claimants are and the extent and amount of their claims. It is too nebulous to delay reorganization at this stage. [II 379–380; emphasis in original.]

4. THE DISTRICT COURT'S DISCHARGE OF THE STOCKHOLDERS COMMITTEE

The district court on May 21, 1965, about a month after it confirmed the amended plan, entered an order discharging the Stockholders Committee "as representatives of stockholders as a class in these proceedings" (III 387). The order recites that, since the court has found the debtor to be insolvent and has confirmed a plan which eliminates all equity of stockholders, "no further services are required of the Stockholders' Committee" (III 388) and that "no useful purpose * * * will be served by continuing to recognize the Committee as a party to these proceedings" (III 389).[12] The discharge order also recites that the Committee had attempted to "litigate issues which have been determined by * * * [the district] court adversely to the Committee's contentions * * * [and] are not in issue before the court * * *" (III 388–389); that reference apparently was to issues the court of appeals later said it had left undecided (*ibid.*; see *supra*, p. 10, n. 10).

5. THE DECISION OF THE COURT OF APPEALS

Stating that "[t]his nine-year-old litigation must at long last be brought to an end," the court of appeals affirmed the orders, *inter alia*, confirming the plan

[12] The Committee has been permitted to prosecute the present appeals (III 389), which include an appeal from the order discharging it.

and discharging the Stockholders Committee. It held (1) that the district court had not abused its discretion in refusing, without a hearing, to consider the stockholders' claims on their merits and (2) that the district court's finding of insolvency was not clearly erroneous. 364 F. 2d 936, 940, 941.

SUMMARY OF ARGUMENT

I

One of the major reforms for corporate reorganizations provided by Chapter X is the requirement that a trustee be "disinterested." The necessity for that neutral quality stems from the role Congress established for the trustee, who is to be the focal point of the reorganization process. While it is the court which is charged with final responsibility over all phases of the reorganization, it is the trustee who conducts the necessary investigation into the debtor's financial condition and who evaluates competing claims to the debtor's assets. He is charged, among other things, with the primary responsibility for drafting a plan of reorganization, and it is through him that the court is able to perform its functions under the Act.

The legislative history shows that Congress considered the requirement that the trustee be disinterested as the keystone of reform. The statute provides that certain circumstances negative disinterestedness, such as a creditor or stockholder relationship with the debtor, or "for any reason an interest materially adverse to the interests of any class of creditors or stockholders." The trustee's interest in future employment in a position of importance with the reorganized company, or the possibility thereof, is materially adverse to the inter-

ests of certain creditors and to the stockholders of the debtor, for, consciously or unconsciously, in areas of dispute, the trustee might lean to those solutions which might best enhance his own prospects. For the same reasons, the district court could not properly find, as Chapter X requires, that the appointment of the trustee as president "is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy."

To insure that a trustee be totally disinterested and that a plan of reorganization be free from any possibility of taint, the trustee should be disabled from becoming president of, or assuming some other position of importance with, the reorganized company.

II

The courts below improperly approved compromises of two seriously disputed claims against the debtor aggregating approximately $2,000,000. The record was not adequate to enable the courts to make the "informed, independent judgment" (*National Surety Co.* v. *Coriell,* 289 U.S. 426, 436) which is necessary before such compromises may be approved in a Chapter X reorganization proceeding. The record does not adequately disclose the grounds upon which the trustee determined to settle the claims on a basis which allowed them almost in full, or upon which the district court approved such settlement as "fair and equitable." The need for a fully informed judicial evaluation of the settlement is particularly important in view of the district court's holding that because of the debtor's insolvency stockholders are

not entitled to participate in the reorganized company. For if, as the record strongly suggests, both of these claims are subject to serious infirmities, then any fair settlement thereof would substantially reduce the creditors' claims allowable against the debtor and, in light of the district court's use of erroneous evaluation standards (see III below), could lead to a finding of solvency and participation in the estate by the stockholders. Moreover, careful scrutiny of the compromises was called for since one of the claimants thereby emerged with a substantial share of the new company and thus a major voice in the selection of its president—an office which that claimant and the trustee contemplated the latter would fill.

A. The trustee's report of investigation detailed how the principal holders of the Caplan mortgage claim had personally profited at the expense of the debtor and to the apparent detriment of the stockholders. Both the trustee and the Commission objected to these claims, but the court held no hearing thereon. Instead, it approved a settlement under which the claims were "compromised" for more than four-fifths of their principal amount, and the only explanation the trustee gave was that he, his attorney, and the attorney for the claimants "worked out" a mutually satisfactory agreement (II 284). The record does not provide any adequate basis for determining whether this settlement was fair.

B. There was similarly no hearing upon the serious and substantial objections made by the Commission and the Stockholders Committee to the bulk of the Merrill-Stevens claims of $1,600,000. The only con-

cession this claimant made under the compromise was accepting the reclassification of the allegedly secured portion of its claim—constituting approximately one-third of the total—as unsecured; there is serious question whether this portion of the claim was secured at all. Merrill-Stevens received approximately 40 percent of the stock of the reorganized company for its total claims. The record does not adequately explain the basis of settlement or the theory upon which the district court determined that contest of these claims was inappropriate.

III

The district court excluded the stockholders from participation because of its finding that the debtor was insolvent. If that determination was not made in accordance with the proper standards of valuation, however, the district court's confirmation of the plan as "fair and equitable" cannot stand. Those words incorporate the absolute priority doctrine under which junior interests cannot be excluded from participation if the value of the reorganized company exceeds the claims of the senior interests. The estimated future earnings of a debtor in reorganization are the primary basis for valuing it. *Consolidated Rock Products Co.* v. *DuBois,* 312 U.S. 510, 526. In valuing the debtor and finding it insolvent in the present case, the district court relied upon its past earnings record and failed to consider "all facts relevant to future earning capacity. * * * including * * * all circumstances which indicate whether or not * * * [the past earnings] record is a reliable criterion of future performance." *Consolidated Rock Products, supra.* The court refused to consider the future growth of the

debtor's business, which the record indicates was likely. Valuing the debtor on the basis of its existing operations, rather than upon an informed estimate of its future earnings when reorganized, may improperly reduce the valuation because of the inherent limitations of a business operated under court trusteeship.

Since the court's valuation rested upon an improper standard, the court of appeals erred in affirming the finding of insolvency as not "clearly erroneous."

IV

It was repeatedly contended on behalf of the debtor's non-management stockholders that the latter had been sold stock by persons in conspiracy with the debtor in violation of the federal securities laws, and that they had claims arising therefrom entitling them to participate under the plan as general creditors. Many of the facts giving rise to the alleged violations of the securities laws were first disclosed in the trustee's report filed in 1960, long after the 1958 bar date for proof of claims, yet the courts below held the stockholders' claims based on that information to be untimely, notwithstanding that no prejudice to any party had been demonstrated. Moreover, since the claims go to the very fairness of the plan itself, the equitable doctrine of laches should not, in any event, bar their consideration.

In alternatively denying the claims as without merit on their face—an issue the court of appeals did not reach—the district court failed to recognize that numerous courts have upheld private causes of action by persons damaged as a result of violations of the federal securities laws, even in the absence of contractual privity. A court with as broad equity powers

as a reorganization court possesses may not close its eyes to the contention that the claims of defrauded stockholders be given equality with, or priority over, the claims of creditors, some of whom, it is alleged, not only participated in the fraud upon those stockholders but also were responsible for the debtor's collapse.

V

The district court erred in discharging the Stockholders Committee on the basis of its finding that the debtor was insolvent, a finding that is a subject of this appeal. Chapter X makes no provision for the discharge of a committee upon a finding of insolvency, and the value of a debtor may sufficiently increase during the reorganization as to require reconsideration of that finding. The statutory purpose of protecting public investors through participation in reorganization proceedings by committees would be defeated if such committees were not permitted to remain in the proceeding until it is finally terminated.

ARGUMENT

I. CHAPTER X OF THE BANKRUPTCY ACT PRECLUDES A REORGANIZATION TRUSTEE FROM BECOMING THE PRESIDENT OF THE REORGANIZED COMPANY; A PLAN THAT SO PROVIDES OR CONTEMPLATES CANNOT BE CONFIRMED [13]

A. THE LEGISLATIVE HISTORY AND STATUTORY SCHEME OF CHAPTER X DICTATE THAT A TRUSTEE BE TRULY DISINTERESTED

One of the major reforms for corporate reorganiza-

[13] Respondent contended in its Reply (pp. 5-7) to our Memorandum in support of the Petition that this issue was not properly before the Court, having been decided by the

tions provided by Chapter X was the requirement in Section 156 that "[a]ny trustee appointed under this chapter shall be disinterested * * *." This requirement was designed to eliminate past reorganization abuses that had resulted from "friendly" trustees.[14] It is clear that Congress contemplated that the disinterested trustee would do more than operate the debtor's business; he was to be the "focal point" for the reorganization.[15] Indeed, in recommending the legislation the Commission informed Congress that "* * * the independent trustee is the key to real reform. In comparison, the other reforms are secondary."[16]

A brief examination of the trustee's duties will illustrate the reason for Congress' concern that he be disinterested. Section 167 of Chapter X provides that the trustee is to report on the desirability of the continuance of the debtor's business; he is charged with conducting any investigation that may be necessary, not only with respect to the debtor's financial condition and its business operations, but also as to any fraud,

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court below on a previous appeal in this case. Plainly, however, the issue is properly presented here. See, *e.g.*, *Mercer* v. *Theriot*, 377 U.S. 152; *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.*, 240 U.S. 251, 257–258.

[14] S. Rep. No. 1916, 75th Cong., 3d Sess. 21, 27 (1938). See generally, Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees*, Parts I and II (1937).

[15] H. Rep. No. 1409, 75th Cong., 1st Sess. 43, 44 (1937).

[16] Hearings before the House Committee on the Judiciary on H.R. 6439, subsequently amended, reintroduced and reported as H.R. 8046, 75th Cong., 1st Sess. 177 (1937) (testimony of then Commissioner Douglas).

misconduct, mismanagement or other irregularities that may have led to the debtor's economic difficulties; and he is to evaluate and report on causes of action in favor of the debtor that may be disclosed by his investigation. He also is to recommend the allowance and disallowance of claims against the debtor (Sections 187; 44 (11 U.S.C. 72)). If it appears that a reorganization might be feasible, he is responsible for preparing a reorganization plan (Section 169). As the House Report pointed out, it is the trustee who "assembles the necessary ingredients" for the plan.[17] And it is on the basis of the trustee's information (see, *e.g.*, Section 169) that "the court and the investors can intelligently decide whether or not proposed plans are fair, equitable, and sound * * *."[18] As the House Report further stated:

> The trustee, as a representative of the court, plays an active role in the formulation and negotiation of plans, and supplies scrutiny and control thereof in the interest of creditors and stockholders. * * * He is made the active head of the reorganization process * * *.[19]

To emphasize that it is the responsibility of the court to pass upon all phases of the reorganization process in no way detracts from the vital role of the trustee. Indeed, it was through him that Congress expected the court to be able properly to perform its functions:

> Only through some such method [as an impartial trustee] can the court be in a position to exercise an informed judgment and to af-

[17] H. Rep. No. 1409, 75th Cong., 1st Sess. 43 (1937).
[18] *Ibid.*
[19] *Id.* at 44.

> ford a critical scrutiny and supervision of the estate at all times. Without its own agent being fully informed and apprised, the court remains too much at the mercy of the competency, vigilance, and integrity (or lack of them) of those who happened to be active in the case. In sum, the independent trustee will put the court in a position to perform its functions adequately in the large, complex cases.[20]

To that end, Section 156 broadly requires that the trustee be "disinterested," *i.e.*, an "impartial" and "independent" "arm of the court."[21]

B. IN ORDER TO INSURE THAT THE TRUSTEE BE DISINTERESTED, HE MUST BE DISABLED FROM BECOMING PRESIDENT OF OR ASSUMING A POSITION OF IMPORTANCE WITH THE REORGANIZED COMPANY

Congress recognized that—

> [I]ncidental to every reorganization * * * are * * * valuable emoluments within reach of those who emerge with control over the new company. *The central problem in reorganiation is to see to it that that power is not exploited by reorganizers but appropriated for the benefit of investors.* * * * So long as [the reorganization] can be governed by the conventions of a few dominant parties, there is great likelihood that that power will not inure to the benefit of the estate. There is greater assurance of it being done if it is placed where it belongs, in the court. It then becomes an asset, so to speak, of the estate. This shift in power, inherent in the device of an independent trustee, is basic and fundamental if the reorganization system is to be reconstituted in the interest of investors.[22] [Emphasis added.]

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[20] *Id.* at 43.

[21] *Id.* at 43, 44, 43.

[22] *Id.* at 44.

Thus, one of the principal reasons for requiring an independent trustee was to prevent control of the reorganization process from being employed by anyone to serve his own ends.

Hence, Section 158 specifically provides that a person "shall not be deemed disinterested" under Section 156 if he comes within three categories of relationships with the debtor,[23] or, more broadly, if "it appears that he has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor * * * or for any reason an interest materially adverse to the interests of any class of creditors or stockholders." We submit that a trustee who intends or contemplates that he will assume a position of importance—here the presidency—in the reorganized debtor company has "an interest materially adverse to the interests" of, here, the "stockholders" of the debtor within the meaning of that provision.

For example, in evaluating disputed claims and recommending what participation in the reorganized company the plan should give to the various stockholder and creditor interests, a trustee might permit the possibility of employment with the reorganized company to influence him—consciously or unconsciously—to favor those solutions that will best en-

[23] If he (1) is a creditor or stockholder of the debtor, or (2) is, or was an underwriter of any of the debtor's outstanding securities or within five years had been an underwriter of any of the debtor's securities, or (3) is, or was within two years of the filing of the petition, a director, officer or employee of the debtor or any such underwriter, or an attorney for the debtor or such underwriter. The breadth of Section 156 is not, we note, restricted to the four circumstances covered by Section 158; see 6 Collier, *Bankruptcy* ¶ 7.08, at 1181, n.6 (14th ed. 1965).

hance his prospects with those who are likely to emerge in control of the new company. The plan might be designed to curry favor with those who will obtain control, or to assist in obtaining control for those interests who favor the trustee's continued employment. His interest in insuring his future is therefore materially adverse to the interests of other claimants and stockholders of the debtor. The phrasing of Section 158(4) is designedly broad, and, we submit, that section applies here.

We are aware, of course, that Section 158 speaks to disqualifying characteristics at the time of the trustee's appointment. But if the requirement of Section 156 that the trustee be "disinterested" is to be efficacious, clearly that quality must endure throughout the proceeding and must, at the very least, be assessed with respect to the plan of reorganization.

A further indication of congressional concern that the trustee be truly disinterested is shown by the provision in Section 156 that, in certain circumstances, an "additional trustee" may be appointed. He—in contrast to the independent trustee—may be a director, officer, or employee of the debtor, but his duties are limited to operation of the business and management of the debtor's property (see Sections 156 and 189). He may not, for example, participate in the principal trustee's investigations or in the drafting of a plan of reorganization. Despite the narrow circumscription of his duties, even the additional trustee—apart from the permitted relationship to the debtor—must be disinterested. *In re Ocean City Auto. Bridge Co.*, 184 F. 2d 726 (C.A. 3); cf. *Meredith* v. *Thralls*, 144

F. 2d 473 (C.A. 2), certiorari denied *sub nom. Consolidated Realty Corp.* v. *Meredith*, 323 U.S. 758. Similarly, Section 191 permits the trustee to employ members of the debtor's former management at compensation to be fixed by the court. In explaining that provision, then Commissioner Douglas stated that if members of former management were "to assist in the conduct of the business," they should not "be allowed to act in a fiduciary capacity" if insistent upon "additional opportunities" beyond the "fair salary fixed by the court," such as "insuring their retention by the reorganized company." [24] If former management officials of the debtor hired by the trustee may not be in a position to bargain for their retention by the reorganized company, it would seem to follow *a fortiori* that the independent trustee himself—whose functions Congress considered "difficult to overemphasize" [25] and who Congress thought "should be as free from 'friendliness' to a party as the court itself" [26]—should be so disabled.

In accordance with policy similar to that underlying Sections 156 and 158, Section 221 provides that when the judge confirms a plan of reorganization he shall be satisfied not only that "the plan is fair and equitable," but also that the appointment of the pro-

[24] Hearings before the House Committee on the Judiciary on H.R. 6439, subsequently amended, reintroduced and reported on H.R 8046, 75th Cong., 1st Sess. 174 (1937).

[25] H. Rep. No. 1409, 75th Cong., 1st Sess. 43 (1937).

[26] *Harkin* v. *Brundage*, 276 U.S. 36, 55, quoted approvingly in the legislative history of Chapter X in criticizing friendly trustees under former Section 77B. See S. Rep. No. 1916, 75th Cong., 3d Sess. 21, 27 (1938).

posed directors and officers "is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy." That feature was explained in the hearings leading to the adoption of Chapter X, as follows:

> [I]n passing on the fairness of the plans * * *, the court would have to specifically concern itself with the question of the management of the new company, whether that management was in the interests of the creditors and stockholders, and whether it was in the interest of the public. That concept of the public interest is the introduction of a new element * * *[27]

The appointment of the trustee to a position of importance with the reorganized company raises an unanswerable question whether "the salient facts necessary for a determination of the fairness and equity of a plan of reorganization," which Congress expected the trustee to make "available to the court and the investors as a routine matter,"[28] were properly investigated and disclosed. In our view, considering the evils which led to the reforms of Chapter X, such appointment cannot be deemed, under Section 221, to be "equitable," "compatible with the interests of" (here) the "stockholders," or "consistent with public policy," and a plan contemplating the trustee's employment by the reorganized company is not "fair and equitable."

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[27] Hearing before the House Committee on the Judiciary on H.R. 6439, subsequently amended, reintroduced, and reported as H.R. 8046, 75th Cong. 1st Sess. 182 (1937) (testimony of then Commissioner Douglas).

[28] H. Rep. No. 1409, 75th Cong., 1st Sess. 43 (1937).

Early in the history of Chapter X, this Court held that where an actual conflict of interest exists, compensation for services rendered may be denied a fiduciary, despite the fact that no fraud or unfairness was shown to have resulted from the conflict. *Woods* v. *City Bank Co.*, 312 U.S. 262. The Court reasoned (312 U.S. at 268):

> * * * [T]he incidence of a particular conflict of interest can seldom be measured with any degree of certainty. The bankruptcy court need not speculate as to whether the result of the conflict was to delay action where speed was essential, to close the record of past transactions where publicity and investigation were needed, to compromise claims by inattention where vigilant assertion was necessary, or otherwise to dilute the undivided loyalty owed to those whom the claimant purported to represent.

More recently this Court pointed out that "one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups." *Wolf* v. *Weinstein*, 372 U.S. 663, 642. We submit that that language is as applicable to a fiduciary's future employment as to his present "security holdings." Although the Court in *Wolf* recognized that the remedy was "indeed a severe one," it found it necessary to "order the restitution of all amounts of compensation and reimbursement received by * * *

[the debtor's management] since the start of the reorganization [a period of almost 10 years]"; to do otherwise might "jeopardize the salutary policies of the statute." 372 U.S. at 654.[29]

The court below seemingly indicated that the touchstone of disinterestedness was whether the proponents of a plan "assured" the trustee of future employment with the debtor or merely intended to recommend it to the court and the board of directors (334 F. 2d at 119–120). Such a distinction would be unworkable in practice; it would place a difficult and unnecessary burden on reorganization courts in Chapter X proceedings to insure that the trustee's self-interests have not been preferred to those he is required to serve. Moreover, it would seriously weaken the protections which the requirement of a disinterested trustee was intended to provide for creditors and stockholders, for the possibility of future employment may create just as great a danger of a conflict of interest as its certainty. Sections 156 and 221 must be deemed to cover both situations if the Act is to achieve the salutary purpose that Congress intended it to serve.[30]

[29] We urge the analogy to *Wolf* as illustrative of the necessity for a prophylactic rule despite its severity, not to suggest that it follows from that case or our position here that this trustee necessarily would have to forego compensation for his work as trustee.

[30] The respondent, in his Reply (p. 11) to the Commission's Memorandum in support of the Petition, referred to the fact that in 1958 the Commission sought to have Chapter X amended to prohibit a trustee or his attorney from being employed by the reorganized company for a period of two years after substantial consummation of a plan. No hearings were held on the bill (H.R. 11589, 85th Cong., 2d Sess. (1958))

In sanctioning the confirmation of the plan of reorganization involving the future employment of the trustee, the court below countenanced a substantial erosion of what has been viewed as the critical safeguard for the protection of all public investors in a corporate reorganization proceeding conducted under Chapter X of the Bankruptcy Act—the totally "disinterested" trustee. Unless the trustee is completely disinterested——that is, free from any factor that, consciously or unconsciously, might tend to cause personal considerations to influence him—he is not able adequately to fulfill those substantial responsibilities and serve those functions that Congress intended for him. We urge, therefore, that a Chapter X trustee may not, consistent with his fiduciary role, accept or contemplate employment with the reorganized company. A rule disabling him from doing so would insure his independence and impartiality.

To be sure, in a rare instance such a rule might operate to the detriment of a reorganized company that might not be able to obtain as proved and as experienced an executive official as the trustee. But we believe that the possibility of that happening in an occasional case is far outweighed by the public interest in insuring the trustee's single-minded devotion towards bringing about a fair and equitable reorgani-

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that was introduced for that purpose. There is no basis for the significance respondent has attached to that largely clarifying proposal, see *Wong Yang Sung* v. *McGrath*, 339 U.S. 33, 47–48; *Black* v. *Magnolia Liquor Co.*, 355 U.S. 24, 26–27, particularly since, in any event, "we deal here with remedial legislation whose language should be given hospitable scope" (*Magnolia Liquor Co.*, *supra*, at 27).

zation—an interest which requires the strict rule which we urge.

C. THE FACTS HERE ILLUSTRATE THE NEED FOR THE PROPHYLACTIC RULE SOUGHT

We discuss in greater detail elsewhere facts relating to the plan of reorganization recommended by the trustee and approved by the court. See *supra*, pp. 11–16; *infra*, pp. 36–49; 56–69. Here we sketch only how certain features of the plan seem to have placed the trustee in a position of conflicting interest, thus demonstrating the need for disabling a trustee from contemplating future employment with the reorganized company.

Throughout this proceeding the trustee and persons who were charged with being principally responsible for the debtor's collapse (the holders of the Caplan mortgage), and persons allegedly further responsible for the debtor's financial difficulties (Merrill-Stevens), have contemplated that the trustee would become president of the reorganized company. Under the 1959 plan, to which the Commission and the Stockholders Committee had objected because the trustee had not conducted the investigation contemplated by Section 167 (II 510, I 127), the trustee became the salaried president of the reorganized company (II 517, 525), while the persons he later charged with having "wrecked" the debtor by "gross mismanagement" emerged in control (see *supra*, p. 7). While the district court's order vacating the order confirming this plan recites that "the Trustee's investigation disclosed facts not known to the Trustee or to the Court" (II 619), the fact remains that an earlier recognition of a trustee's duty to investigate under Chapter X might have disclosed those belatedly discov-

ered facts thereby obviating some of the substantial difficulties with which the stockholders are now burdened (see pp. 59–61, *infra*).

When two plans of reorganization were proposed in 1962, the trustee recommended to the court the internal plan—which specifically contemplated that he would become president of the reorganized company [31]—and opposed the alternative cash plan of selling the debtor's assets to third parties. The trustee's recommendation was based upon his view that an "internal" plan of reorganization was "more fair and equitable" than an external sale or cash plan because the external plan "must give the new owners complete or nearly complete ownership of the debtor and eliminate any prospect for the unsecured creditors to obtain any substantial benefit from the future prospects of the business" (II 660–661). The trustee took no affirmative steps to let it be known that he would "receive and welcome" (II 97–98) external proposals. Further, the district court noted in considering the two plans—one of which provided for the trustee's future employment

[31] On May 2, 1962, during the hearings on approval of the plans, there was introduced into the record a proposed five year contract between the proponents of the plan and the trustee, pursuant to which the reorganized company would employ him as president (II 275, 296–298). This contract is specifically referred to in the internal plan of reorganization (II 707). The court of appeals recognized that the contract was "between the major creditors and the trustee" (334 F. 2d at 119).

As noted (p. 6 *supra*), upon confirmation of the 1959 plan, the trustee resigned in order to assume that office and a successor trustee was appointed. The latter was subsequently removed before the order of confirmation had been vacated and the original trustee was reinstated (I 38, 41).

and one of which did not—that the trustee "would be perhaps inclined to lean to his employment" (II 332).

In addition, there were serious objections to claims of two major creditors totalling approximately $2,000,000. The trustee decided not to pursue those objections and instead recommended plans which allowed the claims almost in full; plans under which one of the creditors (Merrill-Stevens) receives about 40 percent of the common stock of the reorganized company—an interest sufficient to wield a commanding vote in selecting the new president.[32] The trustee's action on these compromises (see pp. 12–15, *supra*) was of critical importance, for as we later show (Point II, *infra*), the court had no record before it or basis upon which to evaluate the trustee's judgment.

We do not suggest that the trustee's recommendations were deliberately designed to promote his personal interest. But the requirement in Section 156 that the trustee be "disinterested" is to avoid even the possibility of such conflicts of interest. And as this Court has stated, the evil is not that conflicting "interests are always corrupt but [that] they are always corrupting" (*Mosser* v. *Darrow*, 341 U.S. 267, 271). See also 6 Collier, *Bankruptcy* ¶ 7.08, at 1181 (14th ed. 1965).

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[32] We are advised that, after the present plan was approved and confirmed, the new board of directors, on August 23, 1965, unanimously elected the trustee president of the reorganized company and the board approved a management contract whereby the trustee was employed for a period of five years at an annual salary of $30,000 plus bonuses and common stock as approved by the Board; and that the district court has ratified all actions of the new Board taken at this meeting.

"A trustee," Judge Cardozo said, "is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard * * *." *Meinhard* v. *Salmon*, 249 N.Y. 458, 464. Under Chapter X, adherence to that standard, we urge, can be assured only if the trustee is disabled from assuming the presidency of or any position of importance with the reorganized company.

II. THE LOWER COURTS' APPROVAL OF THE COMPROMISES OF SERIOUSLY DISPUTED SUBSTANTIAL CLAIMS WAS IMPROPER BECAUSE THE RECORD DOES NOT PERMIT AN ADEQUATE EVALUATION OF SUCH CLAIMS OR DISCLOSE THE BASIS FOR THEIR SETTLEMENT

The court of appeals recognized that the confirmed plan provides for "compromises of approximately $2,000,000 in two seriously disputed claims" (364 F. 2d at 941). Under that plan the $330,000 Caplan mortgage claim is "compromised" by paying the holders thereof $280,500 (the actual consideration they paid therefor) over five years[33] and giving them stock for their interest on the claim; and the Merrill-Stevens claim of $1,628,284 is "compromised" by reclassifying the allegedly secured portion thereof (approximately $575,000) as unsecured, and issuing for the entire claim approximately 40 percent of the common stock of the reorganized company (III 250–252, 282). The record contains no evidence, however, upon which the merits of these claims could be evaluated,

[33] The plan subsequently was amended to provide for the payment of $250,000 immediately upon consummation. See *supra*, p. 13, n.11.

or upon which the district court could have made the "informed, independent judgment" (*National Surety Co.* v. *Coriell*, 289 U.S. 426, 436) which is necessary for approval in a Chapter X proceeding of such important determinations.

While compromises are "a normal part of the process of reorganization,"[34] like other aspects of a plan of reorganization they must satisfy the standard of fairness in Sections 174 and 221(2). *Conway* v. *Silesian-American Corp.*, 186 F. 2d 201 (C.A. 2). Reorganizations are thus unlike litigation between individual disputants, where "there is no occasion for a court to pass on the fairness or unfairness of a compromise settlement." *In re Chicago Rapid Transit Co.*, 196 F. 2d 484, 490 (C.A. 7).[35] Although generally the reorganization courts have a broad discretion in approving compromises upon any reasonable basis, appellate courts "have had no hesitancy to reverse or remand for further consideration orders approving compromise where such orders were found to be an abuse of discretion, or based upon insufficient investigation or information, or not in the best interest of the creditors and stockholders. [Citations omitted.]" *Ashbach* v. *Kirtley*, 289 F. 2d 159, 163 (C.A. 8).

In *Ashbach*, the court set aside an order of the district court which had approved, after a hearing at which no testimony had been introduced, a compro-

[34] *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 130.

[35] Cf. Fed. Civ. P. 23(e), providing that class actions may not be dismissed or compromised without the approval of the court. Class actions, like reorganization proceedings, involve the rights of persons who may be represented by others similarly situated.

mise of a judgment obtained by the trustee in a suit for mismanagement against a person who formerly controlled the debtor. It stated (*id.* at 166) "that there were too many questions left unanswered for the court to arrive at [the necessary] 'informed and independent judgment'" (quoting *Coriell, supra*). "With the paucity of information furnished to the court by the trustee and his counsel, we do not see how that judgment could be properly exercised." *Ibid.* Similarly, in *Conway* v. *Silesian-American Corp., supra,* the Court of Appeals for the Second Circuit reversed the lower court's approval of a Chapter X plan of reorganization, consisting in the main of a settlement of conflicting claims by a group of Swiss banks. The court remanded the case for further proceedings, since it was "compelled to find a lack of sufficient proof of the adequacy of the settlement proposed to justify acceptance of the plan as fulfilling the statutory standards [of fair and equitable]." 186 F. 2d at 212. Likewise, in *In re Chicago Rapid Transit Co., supra,* the court of appeals vacated an order approving a "businessman's settlement" of mutual claims between the debtor and a former lessor, because it was approved "* * * solely on the basis of expediency and the desire to forestall further lengthy and expensive litigation, with no attempt at considering the relative merits of the conflicting claims of the parties." 196 F. 2d at 485.

In the present case, as we shall now show, the record similarly contains insufficient evidence upon which the reorganization court could make an "informed, independent judgment" as to whether the

compromise of these two substantial claims was a fair one. Before the district court could render such a judgment, it was required to evaluate the claims and ascertain the basis upon which they were being settled. For only then could it determine whether the amount in which the claims were being allowed was fair to the security holders.

When the district court initially approved the internal plan, it gave the following explanation of its acceptance of the compromises (II 372–373):[36]

> Negotiations by the trustee and the creditors committee resulted in proposed compromises of the Caplan mortgage claim and the Merrill-Stevens claims, which compromises are included in the Internal Plan of Reorganization, initially filed by the creditors committee. It is the opinion of the court that these compromises are fair and equitable under the circumstances and they are hereby approved for inclusion in the Internal Plan. The court approves the opinion expressed by the attorney for the trustee that no better compromises can be obtained for the debtor, that the prospect of material reduction in the amount of these claims does not warrant the extensive litigation that would otherwise be required, and that the prospect of recoveries beyond the amount of the claims as urged by the Securities and Exchange Commission and the Stockholders Committee is too remote for serious consideration.

[36] The district court added nothing to this explanation when it confirmed the amended plan upon remand following the second appeal, since it erroneously concluded that its approval of the settlement had been already affirmed by the court of appeals (see *supra*, p. 10, n. 10).

> If the unsecured creditors approve the Internal Plan with these compromises, the only class that can object are the stockholders, and the court has found in the Valuation and Insolvency Order that the stockholders have no equity even if these two claims were disallowed in toto. The alternative to approval of these compromises is extensive litigation at heavy expense to the debtor and unnecessary delay in reorganization contrary to the intent and purpose of Chapter X of the Bankruptcy Act.

This statement falls far short of an adequate basis for approving the compromises. It gives no explanation of how the court evaluated the strengths and weaknesses of the claims, or upon what grounds it concluded that a settlement which allowed the claims in major part was "fair and equitable." The suggestion that, if the creditors approved the plan, there would be no other group that would have an interest in the settlement ignores the fact (1) that if the compromises give the Caplan mortgage holders and Merrill-Stevens an excessive amount (as the record strongly suggests), other creditors, had the facts been fully explained to them, might well have rejected the plan, under which they gave up a substantial portion of their claims;[37] and (2) that the stockholders may have an interest since, as shown be-

[37] The court of appeals thought it "significant" that creditors had not complained of the purported compromises (364 F. 2d at 941). In *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 114, however, this Court held that a plan of reorganization which is unfair to some persons may not be approved by the court even though the vast majority of creditors have approved it.

low (pp. 49–56), the district court's finding of insolvency was invalid because it was based on an erroneous standard of valuation. The other stated ground of approval—that the alternative to settlement was "extensive litigation at heavy expense" and "unnecessary delay in reorganization"—is a valid consideration only when weighed against an informed evaluation by the court of the likelihood of successful prosecution of the claims. For litigation and delay always are the alternative to settlement, and whether that alternative is worth pursuing necessarily depends upon a reasoned judgment as to the probable outcome of litigation.

The need for a fully informed judicial evaluation of the settlement is particularly important in this case in view of the district court's holding that because of the debtor's insolvency the stockholders are not entitled to participate in the reorganized enterprise. The trustee's report of investigation of the Caplan mortgage claims and the Commission's submissions indicate that there is serious basis for believing that those claims and the Merrill-Stevens claims should be disallowed in at least substantial part. If these claims are subject to such serious infirmities—and that can only be finally determined upon the basis of a full record—then any fair settlement thereof necessarily would substantially reduce the creditors' claims allowable against the estate. In view of the district court's use of erroneous valuation standards (see point III, *infra*), this could lead to a finding of solvency, permitting participation in the estate by the stockholders. Moreover, the trustee's espousal of these compromises particularly called for

careful scrutiny because under the plan the holder of the largest of the two claims (Merrill-Stevens) acquires 40 percent of the stock of the reorganized company, and thus obtains a major voice in selecting the president of the company—an office to which, as the plan contemplated, the trustee has now succeeded (see *supra*, p. 35, n. 32).

In the light of these considerations, we examine the bases upon which the trustee settled these claims and the district court approved the settlement.

A. THE CAPLAN MORTGAGE CLAIM

The trustee's report of investigation showed that Abrams, Shaffer and Erdman, who were the principal holders of the Caplan mortgage claim,[38] had a dominant influence on the financial affairs of the company, which, according to the report, had been "wrecked by gross mismanagement * * *" (II 584). The trustee stated that "[a]ll the participants in the Caplan Mortgage were privy and acted with the wrongdoers * * *" (II 1096) in exercising a high degree of control over the debtor to take advantage of their inside position in obtaining large amounts of stock at prices below the market (II 611–612). The trustee's report also details how more than 1,800,000 shares of the debtor's stock reached the public through Abrams and Shaffer without registration under the Securities Act of 1933 (II 609–612), and shows that within a year and a half immediately preceding the institution of the reorganization proceeding, purchases and sales of the debtor's

[38] They held of record or through nominees more than two-thirds of the principal amount (II 598–599).

stock by Shaffer and his wife alone resulted in a net profit to the Shaffers of $244,000 (II 605).

The trustee urged that "persons such as Abrams, Shaffer and Erdman * * * should be barred in this equity proceeding from profiting at TMT's expense. Their claims should be reduced by the profits they have made on sales of TMT stock * * *" (II 612). Furthermore, the trustee contended that they "should be required to account for profits made through diversion of corporate opportunities" (II 609). As a minimum, he urged, their claim should be "disallowed in toto or be subordinated to the claims of general creditors, including stockholders who were sold TMT stock in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 * * *" (II 1096).

In 1961, following the filing of the trustee's report, objections to the Caplan mortgage claim were filed by both the trustee (II 1091, 1096) and the Commission (II 1093). No hearings were ever held on the objections. Instead, the claims were compromised for more than four fifths of their principal amount (see *supra*, pp. 13, 36). The only explanation in the record of the basis of this compromise is the following statement by the trustee:

> The compromise of the Caplan claim was worked out between the attorney for that group, my attorney and myself. It was done in a conference the three of us had with the Court. It was completed after considerable deliberations and negotiations. It was submitted to the Court and approved by the Court and that is the way

we came about to reach that conclusion [II 284].[39]

This four-sentence explanation by the trustee of why he virtually abandoned his previous objections to these claims—objections which rested upon a substantial factual basis[40]—casts no light upon the fairness of the compromise. It says only that the trustee, his attorney and the attorney for the claimants "worked out" a mutually satisfactory agreement. It is impossible to tell on this record whether the settlement was a fair one, since there is no basis for evaluating either the merits of the claims or the theory upon which the settlement rested. The district court could not possibly have made an informed judgment upon the issue, yet the making of such judgment was its clear duty before approving, as fair and equitable, a plan embodying that settlement. See *supra*, pp. 36–38. Moreover, in such circumstances the court of appeals could not validly have treated the district court's approval of the settlement as a proper exercise of the latter's discretion, since there was no ascertainable basis upon which the district court exercised any discretion.

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[39] Presumably the trustee's reference to court approval is to whatever informal approval may have been given by the court in the conference alluded to, since, as noted, there has been no hearing on the claims or the objections and no separate order entered approving the compromise prior to confirmation of the plan (*supra*, p. 43).

[40] The investigation underlying the trustee's report covered 14 days of hearings, at which there was taken testimony of 33 persons including all but one member of the Caplan mortgage group. The record of such investigation consists of 2200 pages of testimony and more than 60 exhibits (II 582–583).

B. THE MERRILL-STEVENS CLAIMS

As noted (*supra*, pp. 14–15), under the plan the allegedly secured portion of Merrill-Stevens' claims, $574,580, or about 1/3 of its total claims of $1,628,284, was reclassified as unsecured and the entire claim was allowed (III 251). There was no hearing on the serious and substantial objections made by the Commission and by the Committee to the bulk of these claims (III 405, II 1042). They urged, in substantial detail, that the debtor had meritorious defenses and off-sets or counterclaims to these claims. With respect to the claim of more than $1,000,000 for work done on the Carib Queen, the vessel whose boilers failed on its maiden voyage, they alleged that Merrill-Stevens (a) did not properly adapt the vessel, (b) did not comply with the terms of the contract to do so, and (c) did not properly repair the vessel after its ill-fated maiden voyage (III 406–407, II 1045–1068). The Commission and the Committee also contended that Merrill-Stevens performed work not covered by the original construction agreement, that no agreement had been reached as to the amount the debtor owed for such work and that Merrill-Stevens was required to establish the value of such work before the debtor was liable therefor (III 406, II 1045–1065). Merrill-Stevens filed an answer to the Commission's objections in which it essentially admitted the existence of certain construction deficiencies in the Carib Queen and the failure of the boilers, but disputed that it was responsible therefor (II 1098); it never replied to the Stockholders Committee's objections.

The trustee filed a motion in December 1961 to have the Merrill-Stevens claims allowed summarily without a hearing. The motion stated that two attorneys in the office of the trustee's counsel had examined "the factual data gathered in the trustee's investigation [41] of the objections to the Merrill-Stevens claim, and it is the considered opinion of both attorneys that the possibility is remote of obtaining any reduction, or material reduction, in the amount of the Merrill-Stevens claim by litigating the objections filed against it" (II 22, 26). Objections to the trustee's motion were made by the Commission (II 1073), the Stockholders Committee (II 37), the Department of Justice (II 647) and the Caplan mortgage group (II 636). At the hearing on the trustee's motion, the district judge stated:

> I am concerned myself. I do know that whoever turned that vessel loose with the boilers in it, somebody made a bad mistake. I don't know who it was. [II 36.]

The district court never ruled on the motion, nor has there ever been a hearing with respect to these claims and objections to them.

When the trustee was asked at a hearing in 1962 to give the basis for his compromise of the Merrill-Stevens claims, he read from a letter sent to him by counsel for the Commission which suggested that, be-

[41] The trustee's motion states: "This investigation consisted of an examination of numerous documents assembled by the SEC during its investigation, together with copies of statements made by individuals which had been obtained during the investigation. Also examined were numerous documents and statements furnished by Merrill-Stevens in support of its answer to specification of objections by the SEC" (II 25).

cause of the necessity for proof by testimony of experts and witnesses to events which occurred in 1956 and 1957, it would be helpful if possible to reach an agreement with Merrill-Stevens, and stated: "And that is what I did. I reached an agreement with Merrill-Stevens" (II 284).

Since the alleged compromise does not reduce the amount of the claims allowed, the only thing that Merrill-Stevens is giving up is an allegedly secured position on about one-third of its total claim. But the Department of Justice contended that under maritime law these claims were not secured (II 648), and their status has not been determined. Nor has there been a determination of the value of the vessels that are the alleged security for the claims, or whether the Caplan mortgage represented a prior claim on these same vessels, as the Caplan group contended. All of these determinations were required by Section 197 of Chapter X before the claims could be allowed as secured.

Here, as in the case of the Caplan group claims, the only explanation in the record of the basis for the settlement is that it reflected an "agreement" the trustee had reached with the claimants—an agreement that presumably reflected the "considered opinion" of two lawyers in his counsel's office who, based on their examination of the factual data obtained in the trustee's investigation of the claims, concluded that the possibility of materially reducing the claims was "remote." Moreover, Merrill-Stevens may not be giving up anything by accepting the reclassification of one-third of its claims from secured to unsecured. Once again, it is impossible to determine whether the

settlement is a fair one—whether it reasonably reflects the strengths and weaknesses of the claims, and for what reasons the trustee concluded that, despite the serious questions that the Commission and the Stockholders Committee had raised about these claims, it was not worth contesting them. A more careful analysis by the district court based upon a more detailed record was necessary before such a settlement could be approved. Cf. *Upson* v. *Otis*, 155 F. 2d 606, 614 (C.A. 2) where, in holding that the district court had abused its discretion in approving the settlement of a stockholders' derivative suit, the court of appeals pointed out: "A record consisting in considerable part of colloquies between counsel and the judge is never satisfactory * * *."

In its Protective Committee Report that led to the adoption of Chapter X, the Commission pointed out that unless settlements were "made in light of all of the facts after thorough investigation and publicity" and "negotiated by truly independent committees who are able to deal at arms' length," they raise "grave problems." It noted that security holders in appraising "all of the facts would have no intelligent basis for deciding whether that part of the plan was fair or unfair," and that "[w]ithout such safeguards, plans of reorganization may throttle and suppress just causes of action and deprive security holders of valuable assets."[42] In this case the "compromises" involved an

[42] Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees*, Part I, p. 312 (1937).

abandonment not only of causes of action that might have brought valuable assets into the estate (III 192–193), but of possible offsets to claims against the estate. Although the compromises may have constituted a fair settlement of the competing liens of Merrill-Stevens and the Caplan groups (the factor which apparently primarily induced the district court to approve them, II 370–373), the fairness of such compromises vis-a-vis the public stockholders could not be determined on this record, and the district court therefore erred in confirming the amended plan which embodied them.

III. THE DISTRICT COURT USED AN IMPROPER BASIS FOR VALUING THE DEBTOR, AND ITS FINDING THAT THE AMENDED PLAN IS FAIR AND EQUITABLE CANNOT STAND

1. Chapter X requires that for the district judge to approve and confirm a plan of reorganization he must find, among other things, that the plan is "fair and equitable."[43] This standard incorporates the absolute priority doctrine under which creditors and stockholders may participate under a plan only in accordance with their respective priorities.[44] While this doctrine requires that senior classes must receive full compensation for their claims before junior interests may participate,[45] it also means that creditors are not to receive greater compensation at the expense of stockholders.[46] Since participation by junior interests

[43] Sections 174 and 221(2) of Chapter X.

[44] *Securities and Exchange Commission* v. *United States Realty & Improvement Corp.*, 310 U.S. 434, 452.

[45] *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106; *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510.

[46] Cf. *Knight* v. *Wertheim & Co.*, 158 F. 2d 838 (C.A. 2).

depends upon whether the claims of senior interests have been fully satisfied, whether a plan of reorganization excluding junior interests is fair and equitable depends upon the value of the reorganized company.

In the present case the district court excluded the stockholders from participation because of its finding that the debtor was insolvent. That finding, therefore, was critical to the court's determination that the amended plan is fair and equitable, and if that determination was not made in accordance with the proper standards of valuation, neither the approval nor confirmation of the plan can stand.

This Court has declared that in a Chapter X reorganization proceeding the estimated future earnings of the debtor are the primary basis for valuing it. *Consolidated Rock Products Co.* v. *DuBois, supra,* 312 U.S. at 526 [citations omitted, emphasis added]:

> As Mr. Justice Holmes said in *Galveston, H. & S. A. Ry. Co.* v. *Texas,* 210 U.S. 217, 226 "the commercial value of property consists in the expectation of income from it." Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be

> fair and equitable. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. *But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and conditions of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance.* * * *

This Court also stated (pp. 525–526), that "[u]nless meticulous regard for earning capacity be had, indefensible participation [or, as in the present case, exclusion] of junior securities in plans of reorganization may result."

In valuing the debtor in the present case, the district court relied upon its past earnings record and failed to consider "all facts relevant to future earning capacity * * * including * * * all circumstances which indicate whether or not * * * [the past earnings] record is a reliable criterion of future performance" (*Consolidated Rock Products, supra*). Thus the court indicated that the debtor should be valued "as it now exists" rather than "when reorganized,"[47] and that there were "no possible future prospects other than what is going on" (III 55–56).

The court's failure to use the proper standard of valuation is particularly demonstrated in the follow-

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[47] During the 1962 hearings, the following colloquy occurred between the court and Mr. Mason, former Committee Counsel (II 170):

ing statement it made in 1965 when it declined to change its original determination that the debtor was insolvent (III 211–212):

> The SEC and the Stockholders Committee insist, as they did during the valuation hearings in 1962, that the court should have required evidence of future earnings, subsequent to reorganization, based upon estimates of revenues and expenses after substantial changes in operations and acquisition and substitution of new type vessels and other equipment, and based upon expanded operations expected to take place under private management. However, neither the trustee nor the court can anticipate what the reorganized company will do, and any estimates of future earnings under different circumstances of operation would be speculative and unreliable (III 267).

2. In July 1962 the court determined that the debtor's going-concern value was $2,780,000 by projecting the then current earnings of the debtor (for the first five months of 1962) at the same level for the balance of the year and arriving at estimated earnings before taxes for 1962. The resulting amount, $568,000, was reduced by estimated income taxes to

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Q. But if this enterprise were out from under the proceedings, would it?

The COURT. Well, we are dealing with an organization that is in. Let's assume that it will stay right there and try to get the value. It is not going to get out until it is reorganized.

Mr. MASON. We are trying to get the value when reorganized.

The COURT. That is of no importance to me. Let's value it as it now exists to determine what should be done in these proceedings.

$278,000 and capitalized at 10 percent (II 387.5). Comparing the going-concern value of $2,780,000 with the total claims of approximately $5,400,000 that would be allowed against the debtor, the court found the debtor insolvent (II 387.5–387.6). During hearings held on valuation in November 1964 and January 1965, the trustee declined to make any estimate of future earnings or to place in the record the detailed information necessary for making such estimates (III 141–143, 148–150, 294). The court, without estimating future earnings at all, found that the debtor was "more insolvent" than in 1962 (III 266).

The 1962 determination of valuation recites that the "only reliable factors are what the debtor is doing now" (II 387.7), and the court expressly refused to consider the future growth of the debtor's business, which the record then indicated was likely.[48] While the district court said at that time that the effect of increasing the fleet of vessels and truck trailers was "too speculative and uncertain to warrant consideration" (II 387.4), only three weeks earlier, on June 19, 1962, it had approved the purchase by the trustee of an additional freight-carrying vessel (II 357). As a result of the debtor's continued growth the court authorized the purchase of further revenue producing equipment, and from the time of the valuation hear-

[48] About a month before the court entered its July 1962 order valuing the debtor and finding it insolvent, the trustee petitioned for authority to purchase a fourth vessel (II 310.1), stating: "The trustee has been offered * * * more traffic * * * than the existing three vessels can handle * * * and there is a backlog of merchandise * * * for movement to Puerto Rico" (II 310.1).

ings in 1962 to the hearings following the remand in 1965 its vessels increased from three to five (II 310.1, III 78) and its truck trailers from 331 to 670 (II 222, III 137).[49]

To value a debtor "as it now exists" rather than "when reorganized," may improperly reduce the valuation because of the inherent limitations of a business operated under court trusteeship. Moreover, the current earnings in this case reflected a deduction of reorganization expense which, of course, is not an ordinary business expense (II 267). A proper valuation of a debtor, as reorganized, requires recognition of contemplated changes in operations and acquisitions, and the effect thereof on future revenues and earnings. The lack of any estimate of future earnings at all precludes the court from properly determining the debtor's valuation and the fairness of the plan or reorganization.

3. In approving the order confirming the amended plan, the court of appeals stated that it was not "called on to decide whether the district court has accurately computed the going concern value of the debtor * * * but only whether its decision that the debtor is insolvent is clearly erroneous. * * * The finding of insolvency cannot be held clearly erroneous" (364 F. 2d at 941). But a finding that rests

[49] Assets, and the excess of assets over liabilities, have each increased by over $1,250,000 in the approximately three year period, and the net book value of the estate has thus increased over 65 percent, principally through the investment of earnings in the purchase of new vessels and truck trailers (II 387.2, III 75).

upon the application of an erroneous legal standard is by definition "clearly erroneous," and, as we have shown, the district court's finding of insolvency is here subject to that infirmity.

This Court recognized in *Consolidated Rock Products* that, to a degree, all going-concern enterprise valuations are uncertain and mathematical precision in assuring that no creditor participates beyond his claim is impossible. That consideration, however, makes it all the more important that before a court should conclude that 7,000 stockholders have no further interest in the debtor, it should make "an informed judgment which embraces all facts relevant to future earning capacity * * *" (*Consolidated Rock Products, supra*). The district court having failed to do so, the order of confirmation here should be reversed, as was the order confirming the reorganization plan in the *Consolidated Rock Products* case, since, as in that case,

> * * * On this record no determination of the fairness of any plan of reorganization could be made. Absent the requisite valuation data, the court was in no position to exercise the "informed, independent judgment" [citation omitted] which appraisal of the fairness of a plan of reorganization entails. [312 U.S. at 520.]

On the basis of a properly developed record, it may turn out that the debtor's going-concern value is sufficient to provide an equity for stockholders after the

satisfaction of the claims of creditors with interest—particularly if it should appear that large claims against the debtor have been unfairly compromised in favor of the claimants (see point II, *supra*).

IV. THE COURTS BELOW ERRED IN REFUSING TO CONSIDER THE MERITS OF THE STOCKHOLDERS' CLAIMS BASED ON ASSERTED VIOLATIONS OF THE FEDERAL SECURITIES LAWS

It was repeatedly contended in the district court on behalf of the non-management stockholders of the debtor that many of them had claims against the debtor arising out of the sale of the debtor's stock to them in violation of the federal securities laws, and that these claims entitled them to participate under any plan of reorganization as general creditors.

The Stockholders Committee's contentions were set forth in various documents filed in 1961 and 1962 (see pp. 59–60, *infra*). The Committee stated in a proof of claim filed in June 1962 (II 364–365):

> 1. With the exception of a very minor amount that appears to have been validly issued, the shares purchased by non-management stockholders were issued by the debtor without registration in violation of the Securities Act of 1933 and the Rules and Regulations issued thereunder * * *.
>
> 2. The shares so issued were issued by the debtor in the course of and in pursuance of a conspiracy with its financial advisors, Joseph Abrams and Arthur H. Shaffer, with Dr. Robert Erdman and certain other persons, and were sold in the public market by certain of the conspirators in violation of the Securities Act of

1933 and the Rules and Regulations issued thereunder * * *.

3. Members of the investing public were induced to purchase such shares and to pay high prices for them by false and fraudulent representations made by the debtor and by other members of the conspiracy in violation of law and by manipulative and deceptive devices and contrivances used and employed by the debtor and other members of the conspiracy in violation of the Securities and [sic] Exchange Act of 1934 and the Rules and Regulations issued thereunder.

It was charged, in further detail, that the 1955 and 1956 financial statements issued by the debtor contained an overstatement of assets resulting from improper transactions; that no disclosure was made as to the lack of independence of an accountant who certified the debtor's financial statements; that no disclosure was made of substantial amounts of the debtor's stock issued to other members of the conspiracy for inadequate consideration; that the debtor's stock was exchanged for valueless or substantially valueless services and property, with a substantial block of stock having been issued on the basis of a false and fraudulent appraisal of certain property; that many untrue statements concerning future prospects for the debtor were published as part of a publicity campaign intended to manipulate the market for the debtor's stock; that the debtor issued to one of the conspirators, Joseph Abrams, stock of the debtor in exchange for unregistered securities of another corporation and that later the debtor sold those unregistered

securities to other members of the conspiracy at discount prices (II 365–367).[50]

The court of appeals agreed with the conclusion of the district court that these formal proofs of claim, filed in June 1962, should have been filed prior to the April 14, 1958, bar date for filing proofs of claims and that, even if "the bar date should not apply because many of the details which provide the bases for these claims were unknown until the report of the Trustees' [sic] investigation filed July 1, 1960 * * * [n]o valid reason or excuse is given for the delay * * * until June 1962" (364 F.2d at 939–940). The court of appeals noted that the district court had alternatively held, without a hearing, that these claims were without merit on their face (*id.* at 939); it did not, however, reach that issue.

We shall show that the question of timeliness here does not turn on the filing of formal proofs of claims and that there was no delay in asserting the claims and that, in any event, the district court failed to meet its independent responsibility—apart from any possible equitable bar to the claims—to insure that the plan was fair and equitable to these stockholders on this issue. Since the claims were not considered on the merits by the court below, we shall discuss them only to show sufficiently that they had

[50] The trustee's report of investigation gave substantial support to the fact that these activities were all involved in connection with the investment by members of the public of many millions of dollars (see pp. 42–43, *supra*). As therein stated: "The rise and fall of TMT can be told in the light of circumstances and persons involved in its stock transactions" (II 585).

substantial legal foundation, requiring their full consideration by the district court.

A. IT WAS ERROR TO REFUSE TO CONSIDER THE CLAIMS ON THE GROUND OF UNTIMELINESS

1. The claims were timely asserted. Unlike ordinary creditors who, at the outset of a Chapter X proceeding, are fully aware of their claims against the debtor, the approximately 7,000 stockholders could not know the details upon which violations of the securities laws could be alleged until the trustee's report was filed in 1960, two years after the 1958 bar date. Indeed, as we have noted, the district court's order vacating the order confirming the earlier plan specifically states that "the Trustee's investigation disclosed facts not known to the Trustee or to the Court" (II 619). In these circumstances, the claims cannot be viewed as having arisen before 1960. Cf. *Holmberg* v. *Armbrecht,* 327 U.S. 392. Nevertheless, the court of appeals affirmed the district court's refusal to permit filing after that date, or to set a new date for filing.

The trustee's report was filed on July 1, 1960. Eight months later, in February 1961, the trustee himself stated: "The [Caplan] Claim should be disallowed in toto or be subordinated to the claims of general creditors, including stockholders who were sold TMT stock in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 * * *" (II 1096). The next month, March 1961, the Committee filed a petition for leave to file a Statement of Position (II 962), to which was annexed a proposed statement (II 1037) articulating the right of non-management stock-

holders "to rank in any reorganization as general creditors" (II 1039). The court denied the petition without prejudice to the right of the Committee "to present its views at the proper time in the course of these proceedings" (II 861).

When, in March 1962, the trustee announced that a new plan was being drafted (II 40), the Committee submitted suggestions for the formulation of a plan of reorganization, again asserting the stockholders' claims (II 1074, 1083). When the proposed plans were circulated, the Committee filed proposed amendments, still again urging recognition of the stockholders' claims (II 1086). Thereafter the trustee discussed and rejected these contentions in a report filed with the court and distributed to the parties prior to the 1962 hearings on the plans (II 660, 663). Before the approval of the plan, a formal proof of claim was filed by the Committee (II 363). And a proof of claim was also filed by an individual stockholder on behalf of herself and all others similarly situated (II 358).

No lack of diligence on the part of the stockholders sufficient to call into play the equitable defense of laches has been shown, nor has there been demonstrated reliance by, or prejudice to, any party that may have resulted from the alleged delay in assertion of these claims. On the contrary, as shown above, the Stockholders Committee repeatedly made known its contentions in this regard during formulation of the plans and thus no one could have been prejudiced.

With respect to laches, this Court has held: "Where there has been no inexcusable delay in seeking a remedy and where no prejudice to the defendant has en-

sued from the mere passage of time, there should be no bar to relief." *Gardner* v. *Panama R. Co.*, 342 U.S. 29, 31. Moreover, in *Czaplicki* v. *The Hoegh Silvercloud*, 351 U.S. 525, it was held that an action could not be barred by laches unless the party against whom the defense was asserted had been given an opportunity to introduce evidence "to prove the facts which would negative laches." *Id.* at 534, n. 15.[51] Here, since the stockholders had no hearing, there was no opportunity for them to show their due diligence and timeliness.

The affirmance by the court below of the dismissal of the claims without hearing on the ground that "* * * no valid excuse or reason was given for the delay * * *" of almost two years in filing the formal proofs of claim in June 1962, suggests that the court valued form over substance. As shown, the Committee repeatedly made known to the trustee and to the court its assertions prior to the filing of formal claims, and the trustee discussed these contentions in a report he filed and circulated before the hearings on the 1962 plan. In these circumstances, the absence of a technical "proof of claim," which prejudiced no one, did not justify the district court's refusal to examine the merits of the claims.

2. In any event, we submit it was error not to consider the claims even if the stockholders had not been diligent in pursuing them. The district judge is expressly charged with the independent responsibility of insuring that only fair and equitable plans of reor-

[51] See also, *Baker* v. *Nason*, 236 F. 2d 483, 493 (C.A. 5) (the defenses of laches and estoppel "are affirmative defenses and call for a full hearing of the testimony of both sides").

ganization are approved and confirmed (Sections 174 and 221(2) of Chapter X). Thus, the district court had an independent duty to consider the claims, once they were brought to its attention, in order to make a proper determination of the fairness of the plan in view of the many stockholders and the potential aggregate size of their claims.

In *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 227, this Court approved a district court's reconsideration of a substantial claim that had previously gone unchallenged on the basis of "the broad responsibility laid upon the court for the equity and fairness of the plan as a whole."[52] That case involved a railroad reorganization under Section 77 of the Bankruptcy Act (11 U.S.C. 205). While a plan of reorganization that had been approved by the Interstate Commerce Commission was before a federal district court for approval, an objection was raised to the allowance of a large claim of the parent railroad against a subsidiary in reorganization, a claim that had previously been unchallenged. The objection was made for the first time three years after the objector had purchased his claim at about ten cents on the dollar and ten years after the proceeding had begun. This Court held that, even if the claim had not been presented to the Interstate Commerce Commission, the district court properly considerd it "[i]n view of the functions cast upon the court in such

[52] The dissenting opinion agreed on this point, stating, "Only by examining the matter now could the court be certain whether the treatment accorded the debt by the reorganization plan was fair and equitable." 335 U.S. at 235.

cases * * *." *Id.* at 227. The Court stated (*id.* at 226–228):

> We think that, in the reorganization proceeding, the courts may entertain on their merits objections to a plan even if made by one who might be barred from asserting a cause of action in his own behalf, if the subject-matter of the objections is such that it goes beyond the objector's individual interests and affects the fairness and equity of the plan * * *.
>
> * * * * *
>
> * * * The court will be diligent to protect itself and the public from approval of unfair plans, even by default, and may take for its own use evidence no party would have a right to force upon it. * * *

Of course, in *Comstock* the question was whether the lower courts properly had entertained and accepted untimely objections to claims—and this Court held that they had—whereas here the question is whether they erred in refusing to consider the claims. But this distinction is immaterial. For *Comstock* makes clear that the equitable doctrine of laches should not be applied to consideration of claims of such magnitude as to affect the very fairness and equity of the reorganization plan. Surely, if an unfair plan results from failure to consider claims, there can be little room for discretion in a district court to determine whether or not to invoke the doctrine of laches. Cf. *Young* v. *Higbee Company,* 324 U.S. 204, 214, where, in overturning the decisions of the two lower courts, this Court held that an equitable defense asserted against the person making a contention on behalf of a class in a reorganization should not pre-

clude the granting of relief to the class. We think Chapter X requires that the stockholders be given a hearing on their claims.[53]

B. THE STOCKHOLDERS' CLAIMS HAVE A SUBSTANTIAL LEGAL FOUNDATION

1. The district court's dismissal of the stockholders' claims was based, in addition to the asserted lack of timeliness, on the conclusion that the theory of recovery was "intended to cover stockholders *who acquired their stock on the open market* and not from the debtor"; and that the claims were "vague and indefinite as to who the claimants are and the extent and amount of their claims" (II 379–380; emphasis in original).

The stockholders' claims are premised, *inter alia*, on violations of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b–5 of the Rules and Regulations of the Securities and Exchange Commission promulgated thereunder (17 C.F.R. 240. 10b–5).[54] While neither Section 10(b) nor

[53] Section 196 of Chapter X provides for a hearing where, as here, objections to claims are made by any party in interest. Section 107 requires a hearing in the event of a controversy as to whether "any creditor or stockholder or class" is affected by a plan of reorganization. In addition, Section 206 states that "any creditor or stockholder of the debtor shall have the right to be heard on all matters arising in a proceeding under this chapter," and Section 209 permits "[a]ny creditor or stockholder * * * [to] act in person, by an attorney at law, or by a duly authorized agent or committee."

[54] Our discussion of the liability of the debtor under these provisions should not be construed as an unfavorable reflection upon the possible use of other provisions of the federal securi-

Rule 10b–5 expressly provides for private civil remedies, nevertheless federal courts have permitted private rights of action to those persons injured as a result of violations of these provisions.[55] The district court's holding that the debtor could not be liable to the stockholders because the latter purchased their shares on the open market, rather than directly from the debtor (II 379), ignores decisions holding that under that Section and Rule a lack of contractual privity does not preclude a defrauded buyer or seller of securities from recovering against those who perpetrated the fraud. For example, in *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783 (C.A. 2), it was held that an action under Rule 10b–5 could be maintained by persons who had purchased common stock of the defendant company on the open market in reliance on a false registration statement that related solely to the defendant issuer's preferred stock.[56] Thus, the stockholders had a substantial claim.

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ties law asserted by stockholders. Section 10(b) and Rule 10b–5, and the cases thereunder, have been selected to illustrate that the stockholders have a valid cause of action.

[55] *E.g.*, *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 201 (C.A. 5); cf. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 430–431.

[56] Similarly, in *Miller* v. *Bargain City, U.S.A.*, 229 F. Supp. 33 (E.D. Pa.), where plaintiff, who purchased stock of the defendant company over-the-counter, had relied upon reports and statements issued by the debtor which were allegedly false and misleading, the court denied a motion to dismiss the complaint for violations of Section 10(b) and Rule 10b–5, holding that privity was not a prerequisite to the right of action. For decisions of other courts which have held or stated that a claimant seeking relief under Section 10(b) and Rule 10b–5 is not lim-

2. The respondent trustee suggests in his Reply to our Memorandum in support of the petition (pp. 15–22) that, even if the stockholders' claims were valid, they would necessarily be subordinated to the claims of other creditors. While, like the question of the validity of the stockholders' claims, it is not necessary to resolve that issue here, we point out that there is substantial authority for the defrauded stockholders' participating in the reorganization on an equal footing with general creditors.

The respondent trustee's argument that the stockholders claims, if allowed, should be subordinated is, in our view, an attempt to reverse the determination of parity status of stockholders rescission claims in insolvency proceedings made by this Court in *Oppenheimer* v. *Harriman National Bank & Trust Co.*, 301 U.S. 206. In that case, a defrauded stockholder brought suit against a bank, which had ceased operations, "to recover damages upon an executed

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ited to an action against the other party or parties to the purchase or sale but may proceed against a third party who has committed fraud in connection with the transaction, privity of contract being unnecessary, see, *e.g.*, *Hooper* v. *Mountain States Securities Corp.*, *supra*; *Texas Continental Life Insurance Co.* v. *Bakers Bond Co.*, 187 F. Supp. 14 (W.D. Ky.), reversed on other grounds, 307 F. 2d 242 (C.A. 6); *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9); *Cooper* v. *North Jersey Trust Company*, 226 F. Supp. 972 (S.D. N.Y.); *Freed* v. *Szabo Food Service, Inc.*, CCH Fed. Sec. L. Rep. ¶ 91,317 (N.D. Ill.); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261 (S.D. N.Y.); *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D. N.Y.); *Cochran* v. *Channing Corporation*, 211 F. Supp. 239 (S.D. N.Y.); and *H. L. Green Co.* v. *Childree*, 185 F. Supp. 95 (S.D. N.Y.). But cf. *Joseph* v. *Farnsworth Radio & Television Corp.*, 99 F. Supp. 701 (S.D. N.Y.), affirmed *per curiam*, 198 F. 2d 883 (C.A. 2).

rescission of a sale to him of stock of the bank by means of fraudulent representations made by its president and vice president." *Id.* at 208. This Court, in considering "whether plaintiff's judgment is entitled to share equally in the receivership estate with other unsecured creditors' claims" (at 213), declared "that plaintiff's judgment is entitled to rank on a parity with other unsecured creditors' claims." *Id.* at 215.

Respondent seeks to distinguish *Oppenheimer* on the ground that it arose from a national bank liquidation under the National Bank Act, under which distribution was made not by a court of equity, but rather by an administrative official (the Comptroller of the Currency) who was bound by a statute directing "ratable" distribution on all claims. 12 U.S.C. 194. However, there is nothing in the National Bank Act, the federal securities laws, or the Bankruptcy Act which would suggest that the rule of *Oppenheimer* is inapposite here. Indeed, a comparison of the National Bank Act with Chapter X reenforces the conclusion that the defrauded stockholders in the instant case deserve similar equality of treatment under Chapter X.

While the National Bank Act provides for a "ratable" distribution of assets and Chapter X of the Bankruptcy Act provides for a distribution which is "fair and equitable" (Section 174 and 221(2)), equitable considerations govern both statutes. This Court has stated:

> The National Bank Act provides for the "ratable" distribution of assets of insolvent national

> banks. R.S. § 5236; 12 U.S.C. § 194. * * * Congress has seen fit not to anticipate by specific rules solution of problems that inevitably arise in national bank liquidations. Instead, it chose achievement of a "just and equal distribution" of an insolvent bank's assets through the operation of *familiar equitable doctrines* evolved by the courts. * * *[57]

Similar considerations govern the administration of proceedings under the Bankruptcy Act. See, *e.g.*, *Pepper* v. *Litton*, 308 U.S. 295. Thus, under both statutes, the ultimate standard is one of an equitable distribution of assets.

Moreover, even if the claims of defrauded stockholders would be subordinated to those of certain general creditors, the claims might nevertheless be superior to those of other creditors: those who participated in the fraud or were responsible for the debtor's economic collapse.[58] Until a properly developed record has been made, however, there could be no determination of these matters.

3. A final reason given by the district court for denying on their face the claims based on asserted securities laws violations is that the claims were "vague and indefinite as to who the claimants are and

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[57] *American Surety Co.* v. *Bethlehem Bank*, 314 U.S. 314, 316 (emphasis added).

[58] Cf. *Pepper* v. *Litton*, *supra*, and *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307. As we have noted (*supra*, pp. 43, 58, n. 50) the trustee, in his report of investigation, urged that the Caplan mortgage be "disallowed in toto or be subordinated to the claims of general creditors, including stockholders who were sold TMT stock in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 * * *" (II 1096).

the extent and amount of their claims" (II 379–380). But since there are legal issues common to all or to many of these claims—issues which were not resolved by the district court—it would have been wasteful to require each of as many as 7,000 scattered stockholders to prove his claim before those issues had been decided. As indicated above, the claims may be of such magnitude that the failure of the court to deal with them on the merits undermines the basic fairness of the plan and, hence, it is logical and proper that the Stockholders Committee, as a representative of stockholders, be accorded a hearing on the legal issues involved. Should it then be determined that these asserted claims are valid, the court, in accordance with the provisions of Section 196 of Chapter X, could specify a period of time for and the manner in which the individual claims are to be filed or proved.[59]

We submit that in the instant case the repeated contentions of the stockholders spell out a substantial claim for relief under the federal securities laws which might entitle them to participate as creditors under any plan of reorganization, irrespective of the solvency or insolvency of the debtor. The summary rejection of these contentions precludes a finding that the amended plan is fair and equitable and requires a reversal of the order of confirmation and a remand for an appropriate hearing in the district court.

[59] Other courts have not found it difficult to establish procedures to identify numerous interested persons and process their claims. See, *e.g.*, *Derdiarian* v. *Futterman Corp.*, CCH Fed. Sec. L. Rep. ¶ 91,575 (S.D. N.Y.).

V. THE STOCKHOLDERS COMMITTEE WAS ERRONEOUSLY DISCHARGED

Except for an individual stockholder, the Committee is the only representative of stockholder interests in the proceeding, and it has vigorously represented these interests since September 1957, shortly after the proceeding began. The district court, on the basis of its finding that the debtor was insolvent in 1965, discharged the Committee about a month after it had confirmed the amended plan.[60] That action was erroneous.

Section 206 of Chapter X specifies that "any * * * stockholder of the debtor shall have the right to be heard on all matters arising in a proceeding under this chapter," and Section 209 provides that a stockholder may act "by a duly authorized * * * committee." The statute makes no provision, however, for the discharge of a stockholders committee upon a finding of insolvency, and there are sound reasons why it does not. Substantial increases in the value of a debtor are not uncommon during the course of a reorganization,[61] and such change may require reversal of an earlier finding of insolvency, leading to participation by stockholders. Furthermore, where, as

[60] To the extent the district judge relied on the fact that the Committee sought to litigate issues that had previously been determined, the court erroneously assumed that its determinations had been affirmed in the previous appeal (see p. 10 n. 10 and p. 16, *supra*).

[61] See, *e.g.*, *Chase* v. *Austrian*, 189 F. 2d 555 (C.A. 4) (increase from $1.3 to $38 million during 8-year reorganization); *Chemical Bank Co.* v. *Investors*, 343 U.S. 982, 984 (annual earnings of railroad $18 million greater than original estimate); *Knight* v. *Wertheim & Co.*, 158 F. 2d 838 (C.A. 2); *In re Central States Electric Corporation*, 112 F. Supp. 281 (E.D. Va.), affirmed, 206 F.

here, the determination of insolvency is under appellate review, the possibility of reversal on that issue emphasizes the vital interest the stockholders continue to have in this reorganization. The salutary purpose of protecting the interests of public stockholders—who here number approximately 7000—which the provisions for their participation in Chapter X proceedings through committees are intended to serve, would be thwarted if such committees were not permitted to remain in the proceeding until it is finally terminated.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed, and the cause remanded with instructions to (1) vacate the order confirming the plan, (2) vacate the order discharging the Stockholders Committee, (3) conduct hearings on the solvency of the debtor at which time (a) estimates of future earning capacity made in accordance with controlling principles set forth by the Court will be received and considered and (b) financial and other information concerning the debtor's operations and prospects for the future shall be made available in sufficient detail to all the parties, including the Stockholders Committee and the Commission, so that meaningful estimates of future earnings can be made, (4) conduct hearings on the objections to and compromises of the Caplan mortgage and Merrill-Stevens

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2d 70 (C.A. 4); *Standard Gas & Electric Co.*, v. *Deep Rock Oil Corp.*, 117 F. 2d 615 (C.A. 10); *Standard Gas & Electric Co., et al.*, 36 S.E.C. 247, 255.

claims, (5) consider the stockholders' claims based on violations of the federal securities laws on their merits, and (6) prohibit the respondent trustee from becoming president of or assuming any position of importance with the reorganized company.

Respectfully submitted.

RALPH S. SPRITZER,
Acting Solicitor General.

DANIEL M. FRIEDMAN,
J. NICHOLAS MCGRATH, JR.,
Assistants to the Solicitor General.

PHILIP A. LOOMIS, JR.,
General Counsel,
DAVID FERBER,
Solicitor,
PAUL GONSON,
Special Counsel,
THEODORE SONDE,
THOMAS W. ARMSTRONG,
Attorneys,
Securities and Exchange Commission.

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